

The Political Science of Regulating Bank Risk

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I. INTRODUCTION

The leading edge issue in banking law today is—or ought to be—bank risk. Every issue in banking law, whether it be bank failure policy,¹ entry restrictions,² geographic restrictions on the location of branches,³ product market restrictions on the scope of bank activities,⁴ minimum capital requirements⁵ or lending limits,⁶ was, at least ostensibly, promulgated in order to mitigate the problem of excessive risk-taking by banks. Now that the massive losses facing the federal insurance agencies responsible for protecting depositors' savings have come to represent a realistic threat to the wealth of millions of investors, as well as a significant off-line deficit item on the federal budget, the leading edge issue in banking law is becoming a leading issue in domestic policy as well.⁷

This Article is not another description of the necessity of changing the direction of banking policy to deal more effectively with the all important problem of bank risk. The need for regulatory reform has been firmly established.⁸ The current incidence of bank failures is directly linked to misguided banking policies which not only prevent banks from reducing their exposure to risk by diversification, but

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1. See Macey & Garrett, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 YALE J. ON REG. 215, 236–39 (1988); Macey & Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1172–73 (1988).

2. See 12 U.S.C. § 27 (1982).

3. See 12 U.S.C. § 36 (1982).

4. See 12 U.S.C. § 24(7) (Supp. IV 1986).

5. See *Board of Governors v. First Lincolnwood Corp.*, 439 U.S. 234, 244 (1978) (citing 12 U.S.C. §§ 329, 1816 (1982)); 12 C.F.R. § 225 (1988) (Appendix A—Capital Adequacy Guidelines for Bank Holding Companies and State Member Banks).

6. See 12 U.S.C. § 84 (1982).

7. See Garsson, *FSLIC Action May Be Needed in '88*; Riegle, AM. BANKER, May 26, 1988, §1, at 1 (article concerning Sen. Donald Riegle's statement that bailout of FSLIC will be needed in 1988).

8. For a brief sampling of some recent articles that document the problems in the current regulatory regime, see Fischel, Rosenfield & Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301 (1987) [hereinafter Fischel] (cataloguing a wide range of problems with banking regulation that lead to excessive risk-taking); Gilbert, *Recent Changes in Handling Bank Failures and Their Effects on the Banking Industry*, FED. RES. BANK ST. LOUIS REV. 21 (June/July 1985) (describing problems with FDIC methods of dealing with bank failures); Kaufman, *Implications of Large Bank Problems and Insolvencies for the Banking Industry and Economic Policy*, ISSUES BANK REG. No. 8, Winter 1985, at 35 (describing the destabilizing effects of deposit insurance); Macey & Garrett *supra* note 1 (criticizing current system of bank regulation on the grounds that it induces excessive risk-taking by banks); Macey & Miller, *supra* note 1 (explaining how banking regulation provides disincentives for outside monitoring and suggesting that the market for corporate control of banks be deregulated to attract outside monitoring); Note, *The Modified Payoff of Failed Banks: A Settlement Practice to Inject Market Discipline into the Commercial Banking System*, 73 VA. L. REV. 1349 (1987) (describing how current bank failure policies increase bank risk); J. Macey, M.W. Marr & S.D. Young, *The Glass-Steagall Act and the Riskiness of Financial Intermediaries* (1988) (unpublished manuscript on file with the Ohio State Law Journal) (providing empirical support for the proposition that the Glass-Steagall Act increases the riskiness of banks by depriving them of the benefits of diversification); K. Scott, *Deposit Insurance and Bank Regulation: The Policy Choices*, (1988) (unpublished manuscript on file with the Ohio State Law Journal) (describing flaws in the pricing and administration of federal deposit insurance, and explaining how deposit insurance as it currently is administered exacerbates the problem of excessive risk-taking by banks).

actually provide clear incentives to banks to engage in excessively risky activities.⁹ In particular, as will be seen, the Federal Deposit Insurance Corporation's (FDIC) policies for administering bank failures,¹⁰ and its refusal to price deposit insurance so as to penalize excessive risk-taking by insured banks,¹¹ defy explanation on public policy grounds.¹²

Rather, the purpose of this Article is to consider the reasons why the regulation of banking risk has been handled so badly and to assess the likelihood that change will occur at all. As will be seen, the mere need for reform does not always result in reform. Indeed, this Article predicts that meaningful change is unlikely to occur.

The next Part of this Article invokes a political scientist's perspective to explain why bank regulation reflects the narrow concerns of special interest groups even more completely than does most legislation. The following Part of the Article will explain how current banking laws and regulations benefit the interest groups that represent the banking industry, why bank risk is such an important issue, and how current policies exacerbate the problem of bank insolvency. Finally, the last Part explores the prospects for change.

II. THE FORMATION OF BANK POLICY IN THE AGE OF INTEREST GROUP DOMINATION

The public choice model of government decision-making predicts that banking policy, like other forms of law, is produced by governmental entities, primarily Congress and the relevant administrative agencies, the FDIC, the Comptroller of the Currency, and the Federal Reserve Board, at least in part in order to provide private goods to powerful interest group constituencies. While the public choice model has invoked this theory of governmental decision-making to explain virtually every aspect of governmental behavior,¹³ nowhere does the model appear to be more robust than as applied to banking.¹⁴

The public choice model begins with the assumption that individuals, when making public as well as private decisions, are motivated primarily by private

9. See Macey & Miller, *supra* note 1, at 1173.

10. See *id.* at 1172-92.

11. K. Scott, *supra* note 8, at 7-8.

12. See *supra* text accompanying note 8.

13. See Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983); Lee, *Politics, Ideology, and the Power of Public Choice*, 74 VA. L. REV. 191 (1988); Macey, *Transaction Costs and the Normative Elements of the Public Choice Model: An Application to Constitutional Theory*, 74 VA. L. REV. 471 (1988); Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971); Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339 (1988).

14. See Benston, *Federal Regulation of Banking: Analysis and Policy Recommendations*, 13 J. BANK REG. 216, 222 (1983); Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1 (1984). In fact, the special interest group orientation of certain banking statutes, particularly the Glass-Steagall Act, is so obvious as to be assumed by thoughtful commentators. See Easterbrook, *The Supreme Court 1983 Term: Foreward: The Court and the Economic System*, 98 HARV. L. REV. 4, 57 (1984) (describing the litigation by the Securities Industry Association to apply the Glass-Steagall Act to restrict commercial banks from selling commercial paper as representing its attempt to claim the "spoils of victory" gained by investment banking firms in the legislative process). But see Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 713-16 (1987). See also Jackson, *As Thrift Industry's Troubles and Losses Mounted, Its PACs' Donations to Key Congressmen Surged*, Wall St. J., Feb. 7, 1989, at A22, col. 1.

interests rather than the public interest.¹⁵ So, despite the fact that public decisions (such as the proper direction for banking policy) apply to the entire polity, public choice theory predicts that the outcomes of the decision-making process will be influenced, and, at the margin, determined, by the private interests of the affected decision-makers.

Public choice theory suggests that regulation will divert wealth from relatively diffuse groups towards more organized groups whose members have strong individual interests in the regulation's effects.¹⁶ The interests of those who are not in a position to make themselves heard will not be registered in the calculus that produces the final outcomes generated by the policy-makers. The theory explains that members of large groups (up to and including the largest group of all—the general public) face severe free-rider problems as they try to organize to provide benefits to themselves.¹⁷ Those (usually relatively small) groups that are able to provide their members with incentives for participating in policy formation (or disincentives for not participating) will survive and flourish. Those groups that have a difficult time identifying issues, organizing themselves into effective coalitions, and punishing free-riders will be less successful.¹⁸

This does not mean that law will never serve the public interest. Private interest groups may often be benefited by laws that enhance efficiency or solve public goods problems. Those groups will, on occasion, press for such laws. Laws designed to deter theft, to protect the environment, and to provide for the national defense, for example, benefit a broad range of interests even though they may be championed by a narrow group that especially benefits.¹⁹

In banking regulation, by contrast, the existence of a public benefit often is impossible to ascertain. Restrictions on entry into the business of banking, on banks' ability to branch, on banks' ability to engage in the underwriting of securities, and on the scope of business activities banks can undertake, do not even appear to further the public interest, but rather, appear simply to restrict competition, thereby limiting consumer choice and raising the price consumers must pay to obtain the goods and services provided by banks.²⁰

There are four basic reasons why banking law and policy often do not bear even the appearance of public-spiritedness. All four reasons are rooted in the collective action problem that faces the highly variegated consumers of banking services, who are not in a position to press for laws that benefit overall societal welfare. The well-organized special interest groups that dominate the legislative process, as it

15. Lee, *supra* note 13, at 191.

16. This description is taken from Haddock & Macey, *Regulation on Demand: A Private Interest Model, With an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311, 312 (1987).

17. See M. OLSON, *THE LOGIC OF COLLECTIVE ACTION* (rev. ed. 1971).

18. See M. OLSON, *THE RISE AND DECLINE OF NATIONS* 19–23 (1982).

19. The fact that laws appear to benefit the public does not mean that they in fact benefit the public. Certain laws that appear to benefit the public in fact merely transfer wealth to special interest groups. See Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 228 (1986). Of course, some laws that appear to benefit the public actually do. *Id.*

20. See Fischel, *supra* note 8, at 319–36.

pertains to the banking industry, do not appear to benefit by pressing for regulations that increase efficiency. Rather, these special interest groups appear to benefit most from rules that transfer wealth from less organized consumers to more organized producers.

The first reason why there is little pressure for modern banking law to reflect efficiency concerns is that deposit insurance deprives private sector actors of any reason to concern themselves with excessive bank risk-taking. The second reason is that the administrative agencies regulating banks do not have broad based constituencies. As a consequence, administrative agencies are not forced to resolve disputes among conflicting interests. Rather, their constituencies appear to consist exclusively of highly organized special interest groups. Third, the issues involved in banking regulation do not involve the sorts of concerns that individual citizens are likely to find appealing. Generally, when people express themselves politically, they do so because they find meaning and satisfaction in the political process.²¹ The complex, nitty-gritty sorts of issues that describe the contours of national banking policy do not provide people with the feeling of satisfaction from participating in the political process. Therefore, people whose interests are not directly affected do not participate as they do in other issues such as civil rights and foreign policy.²² Finally, the banking issues that must be confronted are of such a complex and politically unimportant nature that few members of Congress find it in their interest to become very knowledgeable about them. Thus, because legislators are not informed about the issues they are called upon to consider, even the most well-meaning legislators are likely to be highly influenced by special interest groups as they go about formulating banking policies for the nineties.

A. *Deposit Insurance*

A substantial portion of individual wealth, particularly disposable wealth, is tied up in demand deposits at banks. Depositors obviously have a large stake in making sure that these demand deposit funds remain safe. In the absence of deposit insurance, of course, bank depositors would face potential losses whenever the banks in which they had deposits became insolvent. Because of the high stakes involved for individual investors, such investors could be expected to overcome the usual collective action problems facing large groups and galvanize into an effective political force to lobby for protection against excessive bank risk-taking. But, in the presence of deposit insurance these depositors are completely insulated from the consequences of bank failure and have no incentive whatsoever to press for legislation that would make banks less likely to fail.

Depositors are not only insulated from the economic consequences of bank failure, they are also indifferent to the way that bank failure policy is administered by the regulatory agencies. This is because depositors have no reason to concern

21. *Lee*, *supra* note 13, at 193.

22. *Cf. id.* at 196-97.

themselves with the details of how their insurance fund is administered so long as they are repaid promptly in the event of a bank failure.

Some have argued that deposit insurance is efficient. In particular, Fischel, Rosenfield, and Stillman take the position that bank depositors face a collective action problem that comes in the form of a prisoner's dilemma, and that deposit insurance serves to overcome this prisoner's dilemma. According to this argument, rational bank depositors realize that all depositors cannot demand repayment of their deposits simultaneously because the bank does not have sufficient funds on hand at any given time to satisfy its obligations to all depositors.²³ If a significant percentage of depositors attempt to withdraw their funds at the same time, then the bank will be forced to liquidate its assets "at distress prices," thereby rendering the bank insolvent, and jeopardizing the interests of those depositors foolish enough to refrain from making early withdrawals. Thus:

[I]f some class of depositors does decide, for whatever reason, to withdraw assets from the bank, other depositors will rationally conclude that they must do the same to avoid being left with nothing. The result of such a "run" on the bank's assets may be the failure of a previously solvent bank to the detriment of depositors as a group.²⁴

This collective action problem among depositors is no different from the collective action problem among creditors of other businesses. If all creditors demand payment at once, firms will find it difficult to repay everybody.²⁵ But, because banks have such a high percentage of their assets in the form of long term loans, and such a high percentage of their liabilities in the form of deposits that are payable on demand, the problem facing banks is particularly acute.²⁶

Here, however, Fischel, Rosenfield, and Stillman appear to confuse cause and effect. The reason the collective action problem is so acute in banking, they argue, is because of the asymmetry between the maturity structure of banking assets and the maturity structure of banking liabilities.²⁷ But there is nothing preventing banks from designing their asset portfolio to match their liabilities by purchasing highly liquid short-term assets. This would eliminate the collective action problem facing depositors in ways similar to deposit insurance. Thus, the design of deposit insurance makes it possible for banks to have a disparity between the maturity structure of their assets and liabilities. Absent such a design, rational depositors would prefer to place their deposits at banks that matched the maturity structure of bank assets with those of bank liabilities.²⁸

23. Fischel, *supra* note 8, at 307.

24. *Id.* at 308.

25. *Id.*

26. *Id.* at 308-09.

27. *Id.*

28. Note that the ability of banks to securitize their assets makes it increasingly less costly for them to match assets and liabilities. Securitization refers to the process of packaging a group of income-producing assets together and creating a new security which offers the purchaser the stream of income generated by the underlying assets. The purchasers of the new securities provide the selling bank with immediate liquidity, thus eliminating the disparity between long term assets and short term liabilities.

Thus, the FDIC does not appear to be the only solution to the collective action problem facing bank depositors. Indeed, the problem itself does not appear to be particularly intractable because banks themselves can solve the problem by readjusting their asset portfolios to match the maturity structure of their liability portfolios.

A public interest justification for deposit insurance similar to Fischel, Rosenfield, and Stillman's was formulated by Milton Friedman and Anna Schwartz in their seminal book on monetary policy.²⁹ Their claim is that deposit insurance prevents bank runs by protecting public confidence in the banking system:

[T]he knowledge on the part of small depositors that they will be able to realize on their deposits even if the bank should experience financial difficulties prevents the failure of one bank from producing "runs" on other banks that in turn may force "sound" banks to suspend. Deposit insurance is thus a form of insurance that tends to reduce the contingency insured against . . . , namely, the prevention of banking panics.³⁰

But, as Fischel, Rosenfield, and Stillman have pointed out, there is absolutely no evidence that bank failures are contagious in the first place:

[I]t is not clear why a run on any one bank should necessarily unnerve depositors at others. Indeed, there is no reason why depositors at a bank should be more unsettled by a failure of another bank than by the failure of a manufacturing firm. The failure of a large local manufacturing firm may send a signal about the probable quality of a local bank's loan portfolio that is far more relevant to depositors than the signal sent by the failure of a bank in another state.³¹

Unless the failure at the first bank conveys some information to depositors at other banks, there is no reason at all why bank failures should be contagious.³² Indeed, in the likely event that the funds that are withdrawn from one bank are deposited in other banks, these other banks stand to benefit from the failure of the first bank.³³

Thus, the public interest is not served by deposit insurance in any of the ways that have been previously credited. A more likely justification for deposit insurance begins by treating a depositor as another form of investor seeking a safe investment. Deposit insurance increases the safety of bank deposits, but depositors must pay for this increase in safety through lower interest rates on their savings.

Another advantage of insured deposits is that depositors do not have to engage in a costly search process to enable them to distinguish relatively safe banks from relatively risky banks. While banks themselves (particularly healthy banks) would have a strong incentive to do everything they can to help depositors make this distinction, small depositors would still have to invest significant resources in obtaining the expertise necessary to determine which banks offer the best combination of safety and return.

29. M. FRIEDMAN & A. SCHWARTZ, *A MONETARY HISTORY OF THE UNITED STATES, 1867-1960* (1963) [hereinafter FRIEDMAN].

30. *Id.* at 440.

31. Fischel, *supra* note 8, at 310-11.

32. Aharony & Swary, *Contagion Effects of Bank Failures: Evidence From Capital Markets*, 56 J. BUS. 305, 321 (1983).

33. *Cf.* Fischel, *supra* note 8, at 310.

While it is costly for depositors to obtain information about the banks with which they propose to deal, depositors will invest resources in obtaining such information up to the point where these costs equal the expected benefit. This benefit comes in the form of a reduced probability that the depositors will lose their funds. In the absence of federal deposit insurance, however, it is likely that private insurance funds would have evolved to provide depositors with protection in the event of a bank failure.³⁴ Such private deposit insurance might be obtained by the bank itself as a form of third party bonding, or it might be obtained directly by depositors. In either case, these forms of private insurance would force banks to internalize the costs of their own risky activities.

The point here is that, contrary to popular belief, the primary beneficiary of deposit insurance appears to be the insured banks themselves rather than the depositors. This argument becomes almost self-evident when one observes that even during the incredible four-year period from 1930–1933 when 9000 banks failed or suspended operation, losses to depositors came to only 1.3 billion dollars as compared to losses of 85 billion dollars suffered by holders of common and preferred stock.³⁵ Indeed, as Professor Tussig observed in his classic article on the subject of bank failure:

Losses inflicted today upon depositors as a consequence of bank failure may in many cases be less disruptive than a great many ordinary economic hazards of which society takes little or no cognizance. "The failure of a textile mill in a one-mill New England town," Horvitz has recently observed, "is almost certainly a greater community disaster than the failure of the local bank in a one-bank town."³⁶

We protect bank depositors against the loss of their deposits, yet we do not protect workers against the loss of their jobs. This is particularly odd in light of the fact that depositors are in a much better position to protect themselves against the loss of their deposits than workers are able to protect themselves against the loss of their jobs. Depositors can shift their deposits among banks easily and cheaply. Workers, many of whom have large, firm-specific capital investments in the firms for which they work, cannot shift jobs easily or cheaply and cannot obtain insurance against plant closings.³⁷

The above arguments suggest that the public interest justification for deposit insurance may not be as strong as is generally thought. This is peculiar in light of the fact that deposit insurance enjoys overwhelming popular support. Indeed, retention of deposit insurance is probably one of the most revered of sacred cows in the political world. If federal insurance of deposits served only the interests of some narrow interest group coalition, such widespread popular support would be unlikely.

34. *Id.* at 316–17. See also Gorton, *Clearinghouses and the Origin of Central Banking in the United States*, 45 J. ECON. HIST. 277 (1985) (describing the market-generated arrangements that came into being in the days before deposit insurance to make banks less susceptible to systematic failure).

35. FRIEDMAN, *supra* note 29, at 351.

36. Tussig, *The Case for Bank Failure*, 10 J.L. & ECON. 129, 145 (1967) (quoting Horvitz, *Simulating Bank Competition Through Regulatory Action*, 20 J. FIN. 1, 3 (1965)).

37. See Macey, *Externalities, Firm Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. ____.

Nonetheless, it is clear that the costs to the public have been greatly understated, because depositors pay for the benefits they receive from deposit insurance in the form of lower interest rates on deposits, while the benefits to insured depository institutions have been tremendously overstated. This point becomes far clearer when one observes how deposit insurance is administered.³⁸ Most importantly, deposit insurance deprives insured depositors of any incentive at all to press for constructive change in banking regulation. Banks can lobby for unsafe, anticompetitive regulations without fear that consumer groups will challenge the regulations on the ground that they endanger the interests of depositors. The fact that depositors are insured thus deprives the regulatory process of a much needed voice, which, in the absence of such insurance, would fervently press for regulations that protected depositors' interests.

B. *Administrative Agencies' Constituencies*

Capture theory, which was one of the earliest manifestations of what has evolved into the modern economic theory of regulation, posits that over time, regulatory agencies become dominated and controlled by the industries they regulate.³⁹ Unlike later theories, capture theory "singles out a particular interest group—the regulated firms—as prevailing in the struggle to influence legislation, and it predicts a regular sequence, in which the original purposes of a regulatory program are later thwarted through the efforts of the interest group."⁴⁰

Capture theory has not survived as a convincing theory of regulation.⁴¹ Capture theory is particularly unsatisfying where more than one group is regulated by the agency in question.⁴² For example, capture theory is particularly weak at explaining or predicting the actions of the Interstate Commerce Commission (ICC), which regulates such competing modes of transportation as trucks, railroads, and barge lines. Each of these industries exerts influence on the ICC, and the primitive capture theory is incapable of telling us which industry is likely to dominate the regulatory process.

But, by parity of reasoning, capture theory is a much more promising candidate for predicting regulatory behavior where the regulatory agency in question regulates a single industry whose membership has more or less unified interests and goals. This is the case in the banking industry. The Comptroller of the Currency (Comptroller) has primary regulatory responsibility for national banks.⁴³ State banks are regulated by state banking officials, unless they are members of the Federal Reserve System, in which case their primary regulator is the Federal Reserve Board.⁴⁴ Savings banks

38. See *infra* notes 83–90 and accompanying text (discussing the administration of deposit insurance).

39. M. BERNSTEIN, *REGULATING BUSINESS BY INDEPENDENT COMMISSION* 3–4 (1955); See H. ZIEGLER, *INTEREST GROUPS IN AMERICA* 119–20 (1964); Huntington, *The Marasmus of the ICC: The Commission, the Railroads, and the Public Interest*, in *PUBLIC ADMINISTRATION AND POLICY, SELECTED ESSAYS* 58 (P. Woll ed. 1966); Leiserson, *Interest Groups in Administration*, in *ELEMENTS OF PUBLIC ADMINISTRATION* 314 (F. Morstein Marx ed. 1946).

40. Posner, *Theories of Economic Regulation*, 5 *BELL J. ECON. & MGMT. SCI.* 335, 341–42 (1974).

41. *Id.* at 342 (capture theory is still unsatisfying and "lacks any theoretical foundation").

42. *Cf. id.* (capture theory "has no predictive or explanatory power at all when a single agency regulates separate industries having conflicting interests").

43. See generally E. SYMONS & J. WHITE, *BANKING LAW TEACHING MATERIALS* 46 (2d ed. 1984) [hereinafter SYMONS & WHITE].

44. *Id.*

and savings and loan associations are regulated by state authorities or by the Federal Home Loan Bank Board, which administers the Federal Savings and Loan Insurance Corporation (FSLIC).⁴⁵ Thus, each constituency has its own regulatory agency, which is not responsible to other interests. This state of affairs increases the likelihood that bank regulators will succumb to regulatory capture, because, unlike regulatory agencies such as the ICC, the interests of bank regulators are not divided among a large number of constituents.

The one exception to this situation is the Federal Reserve Board (Board), which is not only responsible for regulating state bank members of the Federal Reserve System, but also for conducting the nation's monetary policy, as well as for financing the federal government's budget deficit through the sale of Treasury bills, notes, and bonds. These latter two functions bring the Board into regular contact with investment banks, which purchase these governmental debt instruments for resale to retail and institutional investors. Thus, unlike other bank regulatory agencies, the Board is less likely to conform to the crude capture model of regulatory behavior because investment banks, as well as commercial banks, come under its aegis.

Recent attempts by commercial banks to enter the securities business provide striking examples of both the divided loyalty of the Board and the undivided loyalty of the Comptroller. For example, the Comptroller approved an application by a commercial bank, which already operated a discount brokerage business, to establish an operating subsidiary to provide investment advisory services.⁴⁶ Even though the combination of these two services—discount brokerage and investment advice—enabled banks to offer retail customers every securities-related service that a full service brokerage house could provide, the Comptroller, consistent with the capture theory presented here, had no trouble permitting commercial banks to enter this line of business despite the obvious tension between the Comptroller's decision and the purposes of the Glass-Steagall Act.⁴⁷

When certain large bank holding companies wanted to establish subsidiaries to engage in underwriting and selling commercial paper, they were required to obtain approval from the Board, the federal agency with regulatory responsibility for the activities of all bank holding companies and their nonbank subsidiaries. Section 20 of the Glass-Steagall Act, which forbids affiliations between banks and firms "engaged

45. *Id.*

46. See *Ruling Allows Bank to Offer Investment Advisory Service*, AM. BANKER, Sept. 14, 1983, § 1, at 4.

47. See Macey, *supra* note 14, at 28–29 (the Comptroller's decision "leaves very little of Glass-Steagall intact"). Another example of the divided loyalty of the Board came in the wake of the decision by the Court of Appeals for the District of Columbia that gave the Board regulatory responsibility over the activities of the banking subsidiaries of bank holding companies. See *American Ins. Ass'n v. Clarke*, 854 F.2d 1405 (D.C. Cir. 1988). After this decision, the Board moved quickly "to exert greater control over state-chartered member banks' investment in risky, non-banking businesses such as real estate development." Taylor, *Fed Moves to Require Bank Units to Seek its Approval for Any Outside Businesses*, Wall St. J., Nov. 22, 1988, at A6, col. 5. On January 18, 1989, the Board approved the applications of several bank holding companies to underwrite corporate debt despite strong resistance from the Securities Industry Association. The Board, however, maintained its position that the underwriting of securities such as corporate debt must be conducted by a separate subsidiary and can't generate more than 5% of the subsidiary's gross revenue. Duke, *Fed Moves to Allow Banks to Underwrite Corporate Debt; Equity Powers Withheld*, Wall St. J., Jan. 19, 1989, at A3, col. 2. An interesting question is why the Board deferred for one year its decision on whether banks can underwrite corporate equities. See *infra* text accompanying note 51.

principally in the issue, flotation, underwriting, public sale or distribution . . . of stocks, bonds, debentures, or other securities”⁴⁸ clearly envisions that subsidiaries of bank holding companies (affiliates) will be able to engage in the securities business so long as they are not engaged principally in this business.

Indeed, the United States Supreme Court in *Board of Governors of the Federal Reserve System v. Agnew*,⁴⁹ had indicated that firms would not be engaged in the securities business unless fifty-one percent of their business was derived from securities related activities.⁵⁰ Despite this support for permitting bank holding company subsidiaries to engage in a wide variety of securities activities, the Board will not permit such subsidiaries to derive more than “5 percent of their total gross revenues from . . . [securities activities] over any two year period.”⁵¹

In case there was any doubt that the strict limitation on the ability of bank holding company subsidiaries to deal in commercial paper was anything other than a political compromise with the Board’s other constituency, the securities industry, the Board also imposed a limit on the market share of the commercial paper industry that bank holding company subsidiaries would be able to capture. Securities firms had long been involved in the commercial paper business, and these firms were concerned that their traditional control of the market would be undermined by competition from bank holding company subsidiaries. But the Board had absolutely no statutory or administrative authority for imposing market share limitations on holding company subsidiaries involved in the sale of commercial paper. Nor do such conditions appear to bear any relationship to the ostensible public policies underlying the Glass-Steagall Act.⁵² The apparent public policy purposes for this regulation were to eliminate the conflicts of interest arising from the combination of commercial banking and investment banking and to prevent banks from engaging in an enterprise which was considered to be too risky for commercial banks. Conflicts of interest were said inevitably to arise whenever commercial banks engaged in the securities business, because commercial bankers would do things such as make unsound loans to promote improvident securities sales and render biased investment advice in order to achieve the same goal.⁵³ Intolerable levels of risk were said to arise if banks were allowed to invest their own assets in securities⁵⁴ (although it is impossible to imagine that all

48. 12 U.S.C. § 377 (1982).

49. 329 U.S. 441 (1947).

50. *Id.* at 447–48.

51. *Order Approving Applications to Engage in Limited Underwriting and Dealing in Certain Securities*, 73 Fed. Res. Bull. 473, 485–86 (1987).

52. *Securities Indus. Ass’n v. Board of Governors*, 839 F.2d 47, (2d Cir.), *cert. denied*, 108 S. Ct. 2830 (1988). In overturning the Fed’s imposition of market share limitations, the circuit court ruled that market share limitations were not supported by the Glass-Steagall Act:

We discern no support in § 20 [of the Act] for the Board’s market share limitation. . . . [T]he fact that [the increasing market share of commercial banks in traditional investment banking activities] was brought to Congress’s attention and that Congress did not directly address it is . . . a strong indication that Congress was not concerned about market share.

53. *Id.* at 68. See *Investment Co. Inst. v. Camp*, 401 U.S. 617, 630–33 (1971) (describing the “plain conflict” between the promotional activities of the stockbroker and the “obligation of the commercial banker to render disinterested investment advice”).

54. *Id.* at 630.

investments in stocks are inherently more risky than all investments in other commercial banking activities).⁵⁵

Thus, while all of the administrative agencies that deal with banking regulation appear to respond to pressure from interest groups, only one, the Board, must respond to pressure from a variety of constituencies. The others all face a constituency more or less unified in its preferences for regulation. As a consequence of the regulatory environment in which banks operate, capture theory is likely to provide an unusually useful model for predicting the outcomes generated by the industry's administrative agencies.

C. *The Issues: Complexity and Ennui*

Earlier in this Article, I argued that one of the hidden costs of federal deposit insurance is that it deprives individual depositors of a motive for attempting to make banking regulation more efficient.⁵⁶ But the fact that someone has no personal economic stake in a particular issue does not necessarily mean that they will decline to take an interest in the issue. We commonly observe people taking an active interest in a variety of issues, ranging from aid to the Contras to the plight of the homeless, in which they have no personal economic stake.

People lobby, vote, and engage in other forms of political expression for a variety of noneconomic reasons. Political activities reinforce an individual's sense of community, self-worth, and moral virtue. Political activities also provide people with what Dwight Lee has described as "ideological satisfaction."⁵⁷

[P]eople receive satisfaction from participating in processes they feel are important, from supporting things they believe are good, and from opposing things they believe are bad. People are motivated to go to the polls and vote for much the same reason they are motivated to go to the sports arena and cheer. It is the satisfaction that comes from participation and expression, not the expectation that they will determine the outcome, that draws people to the polls and to the sports arena. There is no more difficulty reconciling voting with private interest than there is with reconciling attendance at sporting events with private interest.⁵⁸

Unfortunately, the sorts of rules that influence whether banks will operate safely do not provide individual voters with meaningful outlets for ideological expression. This is particularly true for issues involving bank risk.

The existence of deposit insurance creates the need to design regulatory strategies that reduce banks' levels of risk-taking to acceptable levels. Deposit insurance, like other forms of insurance, creates a moral hazard problem from the perspective of the insured parties. In other words, deposit insurance makes it more attractive for banks to engage in risky activities because a portion of the costs of these risky activities is borne by the insurance companies.⁵⁹ In the private sector, a variety

55. See Macey, *supra* note 14, at 11.

56. See *supra* text accompanying note 38.

57. Lee, *supra* note 13, at 195.

58. *Id.* at 193.

59. Fischel, *supra* note 8, at 314.

of mechanisms are used to control this moral hazard problem.⁶⁰ Once the decision to employ federally administered deposit insurance programs is made, a major task of those who administer the programs is to select among these various mechanisms the combination that will be most effective in reducing bank risk. Despite the importance of these issues, these decisions are not the type that the average voter will find interesting or ideologically appealing.

In many corporate settings, the problem of excessive risk-taking is mitigated because a firm's managers prefer to engage in a lower level of risk-taking than that considered optimal by the shareholders. In these firms, shareholders face coordination cost problems and monitoring cost problems that make it difficult for them to detect and punish this sort of managerial misbehavior.⁶¹ Most banks, however, do not have this protection against excessive risk-taking because they are owned by holding companies, which means that they have but one shareholder. Thus, problems of monitoring and coordination are eliminated. Moreover, many small banks are closely held, so that they too, are unlikely to engage in levels of risk-taking that are suboptimal from the shareholders' perspective. Therefore, unlike many firms, banks will engage in levels of risk-taking that are close to optimal from the shareholders' perspective.

Similarly, other issues regarding bank risk, such as what lines of business are appropriate for banks, what types of geographic restrictions, if any, should be imposed, what minimum capital requirements should be maintained, or what bank lending limits should be, are not the kind of issues in which the average citizen will choose to become immersed. Thus, unlike many regulatory agencies, banking agencies are not going to find themselves confronted with an array of consumer groups when they are called upon to make policy as it relates to bank risk.

D. *Issue Complexity and Capture Theory*

The final reason why banking regulation is likely to conform especially well to capture theory is that the issues are so complex. Extremely complex regulatory issues are especially likely to be resolved in ways that benefit special interest groups for three reasons. First, it simply does not pay for politicians to inform themselves about such issues in sufficient detail to make informed judgments about what is in the best interests of their constituents. Politicians cannot come close to mastering all of the details of the incredible array of issues with which they are confronted on a daily basis. The committee system was designed, in part, to enable legislators to specialize in particular issues. It has long been recognized that congressional committees, which are largely staffed by the legislators who have the largest stake in a particular policy area,⁶² have enormous power.⁶³ It is also clear that committee members have

60. *Id.* at 314 (citing deductibles, co-insurance, and risk-related premiums as examples of devices that "force the insured to internalize the costs of engaging in risky activities").

61. See Macey & Miller, *supra* note 1.

62. Riker & Weingast, *Constitutional Regulation of Legislative Choice: The Political Consequences of Judicial Deference to Legislatures*, 74 VA. L. REV. 373, 386 (1988) [hereinafter Riker].

63. See Baron & Ferejohn, *Bargaining and Agenda Formation in Legislatures*, 77 AM. ECON. REV. 303 (1987);

substantially more influence over particular regulatory outcomes than do legislators who are not members of the relevant committee.⁶⁴ In large part, the evidence shows that the ability of legislative committees to formulate the agenda of a proposed legislative package gives the committee extraordinary power.⁶⁵ Although the complexity of the issue already gives the legislative committee a virtual monopoly on the relevant information about the pros and cons of a proposed legislative package, the committee's power is further enhanced because it does not pay for other lawmakers to become informed about the intricacies of the policies under the command of the relevant committee. Thus, in an area such as banking, the deference typically afforded to the relevant congressional committees is especially great.

Second, complex issues, such as those involved in controlling excessive risk-taking by banks, are likely to be resolved in a way that benefits special interest groups because complex issues are likely to produce complex statutes. Complex statutes can be touted as serving a generalized public interest when they really serve the narrow goals of special interest groups. Put another way, the complex statutes necessary to meet the problems of excessive risk-taking by banks can be easily designed to mask what I have termed "hidden-implicit" deals with special interest groups.⁶⁶ Hidden-implicit statutes are statutes that are couched in public interest terms in order "to avoid the political fallout associated with blatant special interest statutes,"⁶⁷ but actually, are designed to transfer wealth to a special interest group.

Third, special interest concerns are likely to dominate statutes designed to deal with the problem of excessive risk-taking by banks because the cost of obtaining sufficient information to make an informed judgment about complex issues provides a decisive advantage for special interest groups. From the perspective of the general public, the process of making public policy is plagued by what political scientists call the problem of rational ignorance. Rational ignorance refers to the fact that "members of the mass public will generally find it irrational to obtain the information necessary to identify their interests on any given issue and moreover will be ill equipped to interpret any information they do obtain."⁶⁸ It is irrational for members of the general public to obtain information about issues concerning bank risk not only because the probability that such information can be used to affect legislative outcomes is very low, but also because obtaining such information is very costly. By contrast, it is cost effective for special interest groups such as banks to obtain information about the issues pertaining to bank risk because they obtain this information during the course of their ordinary business operations. These special interest groups (such as the American Bankers Association) inevitably will present to

Denzau & Mackay, *Gatekeeping and Monopoly Power of Committees: An Analysis of Sincere and Sophisticated Behavior*, 27 AM. J. POL. SCI. 740 (1983); Shepsle & Weingast, *Institutional Foundations of Committee Power*, 81 AM. POL. SCI. REV. 85 (1987).

64. Riker, *supra* note 62, at 387; Weingast, *The Congressional-Bureaucratic System: A Principal Agent Perspective (With Applications to the SEC)*, 44 PUB. CHOICE 147 (1984).

65. Riker, *supra* note 62, at 386-88.

66. See Macey, *supra* note 19, at 233.

67. *Id.*

68. M. HAYES, *LOBBYISTS AND LEGISLATORS: A THEORY OF POLITICAL MARKETS* 69-70 (1981).

legislators the version of the facts that is most favorable to their point of view. The legislators will not receive any other viewpoint because only interest groups find it worthwhile to invest the resources to obtain, systematize, and convey arguments about such a complex issue to Congress. Thus, when it comes to a complex issue like bank risk, even well meaning, public-regarding legislators are likely to be misled into blindly following the policy course preferred by special interest groups because such groups will dominate the flow of information that these legislators receive.

III. TO THE VICTORS GO THE SPOILS

The above Part has outlined four reasons why capture theory is likely to provide an unusually robust model of agency behavior in the realm of banking industry. First, unlike other areas of regulation, and because of deposit insurance, banking consumer groups have no incentive to press for regulations that promote bank safety and soundness. Second, unlike many administrators, bank regulators, with the exception of the Board, do not have to answer to a "multi-industry 'clientele.'" ⁶⁹ Third, banking regulation does not present individual voters with salient issues that provide useful vehicles for ideological expression. Finally, the complexity of the issues in banking regulation creates a situation in which it will be in the interests of only a small number of politicians to invest sufficient resources to become knowledgeable enough to participate meaningfully in policy debates. These politicians will easily be able to respond to industry pressure in such a way that it appears that they are acting in the public interest.

This Part describes some of the ways in which banking law and regulation has come to benefit the interests it supposedly controls by actually making banks more risky. It is important to emphasize, however, that the argument here is not that banking policy specifically is designed to increase bank riskiness. Rather, the argument is that banking laws and regulations provide pervasive benefits to the banking industry, but pay virtually no attention to addressing the basic reason for the increasing incidence of bank failure: current regulations subsidize excessive risk-taking by federally insured banks.

A. *The Glass-Steagall Act*

Section 16 of the Glass-Steagall Act (Act)⁷⁰ prohibits banks from underwriting, selling, and dealing in securities.⁷¹ Section 21 prohibits persons and firms "engaged

69. The phrase is taken from Posner, *supra* note 40, at 342.

70. The Glass-Steagall Act is the popular name for §§ 16, 20, 21, and 32 of the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C. (1982 & Supp. IV 1986)).

71. Section 16, codified as amended at 12 U.S.C. § 24(7) (1982 & Supp. IV 1986), provides that: The business of dealing in securities and stock by the [national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [national bank] shall not underwrite any issue of securities or stock. . . . Section 16 contains exceptions for municipal bonds and debt obligations of the United States Government, as well as for purchases and sales "without recourse, solely upon the order and for the account of customers." *Id.*

Section 5(c) of Glass-Steagall makes the restrictions imposed by § 16 applicable to state chartered banks that are members of the Federal Reserve System. See 12 U.S.C. § 335 (1982 & Supp. IV 1986) ("State member banks shall be

in the business of issuing, underwriting, selling, or distributing . . . stocks, bonds, debentures, notes, or other securities” from offering checking or savings accounts.⁷²

The public interest justification for the Act was that the commercial banks shouldered a large share of the responsibility for the Depression because of the speculative securities activities of their affiliates.⁷³ According to Congress, these affiliates made “one of the greatest contributions to the unprecedented disaster which has caused this almost incurable depression.”⁷⁴ This public interest justification for the Act is extremely implausible.⁷⁵ If the securities activities of bank affiliates really were to blame for the Depression, then the Act should have prohibited such activities. But, as seen above, Section 20 of the Act permits bank affiliates to deal in securities, so long as such affiliates are not “engaged principally” in such activities.⁷⁶

The better argument seems to be that the Act was designed to benefit both commercial banks and investment banks by restricting competition in both industries.⁷⁷ Upon passage of the Act, there was an immediate diminution in the supply of both commercial and investment banking services, as investment banks departed from the commercial banking business and commercial banks ceased their

subject to the same limitations and conditions with respect to the purchasing, selling, underwriting and holding of investment securities and stock as are applicable in the case of national banks under paragraph ‘Seventh’ of section 24 of this title.”) The Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552, *reprinted in* 1987 U.S. CODE CONG. & ADMIN. NEWS 566-72, makes the restrictions of § 16 applicable to state chartered banks that are not members of the Federal Reserve System.

72. Section 21, codified as amended at 12 U.S.C. § 378(a)(1) (1982), provides that:

[I]t shall be unlawful for any person . . . or . . . organization, engaged in the business of issuing, underwriting, selling, or distributing . . . stocks, bonds, debentures, notes, or other securities, to engage at the same time . . . in the business of receiving deposits.

73. S. REP. NO. 77, 73d Cong., 1st Sess. 1, at 6-7 (1933).

74. 75 CONG. REC. S9887 (1932) (remarks of Senator Glass).

75. Recently, Professor Donald Langevoort proffered a new public interest justification for the Glass-Steagall Act’s separation of commercial and investment banking. He claims that “[p]robably the most underestimated recurrent political goal in banking regulation has been that of influencing the use of funds in the financial system.” Langevoort, *supra* note 14, at 683. “Channelling” is the term that has been used to describe the legislative goal of influencing how funds are used within the financial system. *Id.* As applied to Glass-Steagall, it is Professor Langevoort’s contention that Congress was troubled by the fact that during the 1920’s banks often loaned money to individuals and securities firms to help them finance securities purchases. *Id.* at 694. In fact, Langevoort claims that the discovery that 41% of all commercial bank assets were invested in securities or securities related loans was “the most significant statistic leading to eventual passage of [the Glass-Steagall Act].” *Id.*

Langevoort’s analysis is questionable in light of the fact that Glass-Steagall did absolutely nothing to prohibit commercial banks from making loans to individuals for the purpose of buying securities, or from making loans to securities firms for the same purpose. Indeed, Langevoort’s analysis is rather ironic in light of the fact that during the stock market crash of October 1987, the hesitancy of commercial banks to extend credit to securities firms was a source of great concern to regulators, particularly the Federal Reserve Board, which reportedly exerted significant pressure on commercial banks to extend funds to brokerage houses in need of cash.

But the major flaw in the argument that Glass-Steagall somehow was intended to channel banking activities in a particular direction is that bank lending and securities underwriting, which Glass-Steagall attempts to separate, are substitutes for one another. Thus, Langevoort’s argument that lending by commercial banks to individuals and firms involved in the securities business deprived other businesses of capital is untenable because the securities firms that received this money from commercial banks were using it to supply businesses with capital by purchasing and underwriting corporate debt and equity.

76. See *supra* text accompanying note 48 (describing § 20 of Glass-Steagall). For additional arguments that the Glass-Steagall Act serves private rather than public interests, see Macey, *supra* note 14.

77. Macey, *supra* note 14, at 17.

investment banking activities.⁷⁸ Barriers to entry in both industries would ensure that the gains from cartelization would endure.⁷⁹

The Act, however, does nothing to further the interests of bank safety, and in all likelihood, actually makes banks more risky by preventing them from attaining a low-cost means to diversify their loan portfolios. It is clear that underwriting securities is no more dangerous than traditional commercial banking activities such as making loans. The decision by a bank to make a commercial loan is no different than the decision of a trader at an investment bank to purchase a corporate bond or other security. The key elements of both decisions are: 1) the riskiness of the investment, 2) the return on the investment, and 3) the effect of the investment on the overall riskiness of the firm's portfolio. But, unlike most commercial loans, securities can be easily sold in pre-existing, well-established secondary trading markets. This means that firms that purchase securities, unlike firms that make loans, can dispose of their investments quickly in the event of changing market conditions or other circumstances. In addition, highly liquid options and futures markets make it possible to hedge securities portfolios against market risk. Thus, it is not possible to maintain that investment banking is inherently more risky than commercial banking.

Indeed, as Fischel, Rosenfield, and Stillman have pointed out, modern corporate finance theory demonstrates that combining traditional banking activities with nonbanking activities such as investment banking "may reduce the overall riskiness" of the bank because the combination of these activities makes it possible for the bank to obtain the benefits of a portfolio effect for its assets.⁸⁰ Specifically, if bank portfolios can include investment banking activities that do well when its traditional banking activities are doing poorly, it will reduce its overall level of risk. Thus, by denying banks the opportunity to diversify their asset portfolios, the Act forecloses one avenue by which banks could reduce the probability of insolvency.

B. *The Pricing of Deposit Insurance*

Perhaps the clearest example of a bank failure policy that promotes excessive risk-taking by banks is the pricing of deposit insurance. Banks are charged a flat rate

78. It is sometimes said that the only interest group to benefit from the Glass-Steagall Act was the investment banking industry. See Macey, *supra* note 14, at 16 (Glass-Steagall "represents the triumph of one special interest group, the investment bankers, over another interest group, the commercial bankers."); Benston, *supra* note 14, at 222 ("the evidence supports the belief that the investment bankers and underwriters were concerned about severe competition from banks and bank affiliates and sought (successfully in 1933) to eliminate those competitors"); Langevoort, *supra* note 14, at 691 (claiming that those who approach the Glass-Steagall Act from an interest group perspective believe that "the Act is simple special-interest legislation on behalf of the investment banking community"). But it seems clear that Glass-Steagall benefited commercial banks by insulating them from competition from investment banks for deposit dollars, as well as benefitting investment banks. In this way, the politicians who supported Glass-Steagall can be seen as maximizing their political support from both of the interested special-interest groups. This model is consistent with the private interest paradigm elaborated by Peltzman. See Peltzman, *supra* note 13; see also Haddock & Macey, *supra* note 16, at 319-24 (describing the political support maximization model in graphic form).

79. In commercial banking the barriers to entry come in the form of entry restrictions imposed by state and federal chartering authorities. See Butler & Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 684-89 (1988) (describing entry restrictions). In the securities industry, which has long enjoyed heavy concentration and high profitability, the entry restrictions appear to come from the fact that reputational capital is a prerequisite to successful entry.

80. Fischel, *supra* note 8, at 320.

of one-twelfth of one percent of insured deposits each year by the FDIC or the FSLIC.⁸¹ The premium charged by these federally sponsored insurance agencies "is assessed at a uniform rate to all institutions; no recognition is taken of the variations in risk presented by variations in the composition of asset portfolios, in the matching of asset and liability durations, in leverage . . . in managerial competence or in other factors relevant to failure."⁸²

Imagine an automobile insurance company charging the same premia to all clients, from those with several convictions for drunk driving to those with perfect driving records. Such a scheme would transfer wealth from safe drivers to risky drivers.⁸³ Similarly, deposit insurance, by not charging higher premia to risky banks, constitutes a federal subsidy to those shareholders of federally insured depository institutions who cause their banks to engage in excessively risky activities.

Because of the way deposit insurance is priced, banks are not penalized by the market when they shift their assets from relatively less risky to relatively more risky investments:⁸⁴ "[T]he uniform premium structure creates an incentive for the bank to take higher risks than it would otherwise choose."⁸⁵ Moreover, the bigger the risks a bank takes, the bigger the subsidy received by bank management. This is because fixed price deposit insurance puts shareholders of an insured bank in the same position as owners of an option to "sell" the bank to its federal insurers whenever the value of the enterprise falls below the face value of the bank's assets.⁸⁶ This sort of option contract is called a put option because it gives the owner the right to sell, or "put," the underlying asset to the other party.⁸⁷ Generally, buyers of put options are gambling that the value of the underlying asset (in this case the bank) will decline because the option owner can then buy the underlying asset at the new, lower price and then sell it to the other party at the higher price specified in the option contract.

The fact that fixed price deposit insurance has the same characteristics as a put

81. Because of recent demands on the FSLIC, the FSLIC currently is permitted to charge a special assessment of 1/8 of 1%.

82. K. Scott, *supra* note 8, at 7. Recent initiatives to reform the deposit insurance scheme, either by implementing a risk-based premium pricing system, or by lowering the maximum amount of insurance from its present level of \$100,000, are unlikely to succeed due to political opposition from Congress and the Treasury Department. See Norton, *When You're in a Hole, Stop Digging*, U.S. NEWS & WORLD REP., Jan. 23, 1989, at 46.

83. Actually, in a world of competition among insurance companies, no safe drivers would purchase their insurance from this company because companies that divide their insurance pools into safe drivers and risky drivers would be able to offer lower rates to the safe drivers, and thereby out-compete an insurance company that failed to offer a lower rate to safe drivers.

84. Other firms are penalized by the market because as firms become riskier they must pay more to attract funds. See Macey & Garrett, *supra* note 1, at 218-19.

85. K. Scott, *supra* note 8, at 8; see also Macey & Garrett, *supra* note 1, at 219 ("fixed-priced deposit insurance . . . benefits bank shareholders rather than depositors, as is generally thought, because a firm's stockholders, as residual claimants to the firm's earnings, prefer the firm to pursue risky projects, whereas fixed claimants such as depositors, do not"). See also Fischel, *supra* note 8, at 314:

As an illustration, consider two worlds—one where all deposits are uninsured and another where all deposits are insured at a fixed insurance premium. In deciding whether to make an exceptionally risky loan, the bank in the world of uninsured deposits must consider the probability that adding the loan to its portfolio of assets will force it to pay more to attract and preserve deposits. In contrast, the funding costs of the bank in the world of insured deposits and fixed insurance premiums are unaffected by the risky loan. Therefore, at the margin, the bank in the second world has an incentive to make risky loans that it would not make but for insurance.

86. *Id.*

87. *Id.*

option provides bank shareholders with incentives to engage in high levels of risk taking because:

[o]ne of the central principles of option pricing theory is that the value of an option varies directly with the riskiness of the underlying asset. Therefore, when the price of insurance is fixed, increasing the riskiness of the loan portfolio increases the value of the deposit insurance/put option, which redounds primarily to the benefit of the residual claimant—bank shareholders.⁸⁸

C. *Bank Failures*

The two most important components of bank failure policy concern the issue of when an insolvent bank will be declared insolvent and the issue of how the assets of a failed bank will be distributed after the decision to declare the bank insolvent has been finally made.

As used here, a bank is considered “insolvent” when the present value of its assets exactly equals the present value of its liabilities. Holders of equity interests in the firm are wiped out at the moment of insolvency. But, if a bank can be closed at the precise moment of insolvency, all fixed claims can be paid, and there will be no losses to depositors or to the federal deposit insurance fund.⁸⁹ As will be seen, current policies regarding the disposition of insolvent banks cannot be reconciled with the public interest.

1. *The Timing of Bank Insolvencies*

Timing the declaration of insolvency is crucial because if a failed bank remains open after it is economically insolvent, the shareholders, who have nothing more to lose if the bank continues its downhill slide, have a strong incentive to “roll the dice one more time,” or, in other words, to take extremely high risks in hope of a huge payoff that will restore the value of their equity. But despite the fact that the FDIC is the federal agency charged with administering the insurance fund for failed banks, as well as for acting as the receiver for national banks, it does not have the power to close an insolvent bank, or to petition a court for appointment of a receiver for an insolvent bank.⁹⁰

Instead, the Comptroller has the responsibility for closing FDIC insured national banks, while the relevant state regulator has the authority to close state banks. These state regulators do not have nearly the same incentives as the FDIC does to close insolvent banks in a timely fashion because, unlike the FDIC, their performance is not evaluated on the basis of whether they have preserved the economic integrity of the deposit insurance fund. Rather, if these state regulators succumb to political

88. *Id.* (citing Black & Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973)). See also Moore, *The Bust of '89*, U.S. NEWS & WORLD REP, Jan. 23, 1989, at 36, 38. The article describes how Texas developers would take over small savings and loans and “turn them into high-performing investment vehicles.” For the developer, “[t]he beauty of it was that if their S&L gamble failed, they could walk away from it and federal deposit insurance would pick up the tab. ‘Heads I win, tails FSLIC loses,’ was how they put it.” *Id.*

89. This analysis assumes that the transaction costs of liquidating the bank are treated as a fixed claim, so that the bank will be insolvent when the present value of its liabilities, plus the costs of liquidating the bank, equals the present value of the bank’s assets.

90. SYMONS & WHITE, *supra* note 43, at 600.

pressure from the entities they regulate, and forbear from closing insolvent banks, they receive the political benefits in the form of increased support from the regulated entities, while all of the political costs are borne by the FDIC. For example, picture a state FDIC insured bank that is losing 10,000 dollars a month. After the bank is declared insolvent, those (mostly local) individuals and firms that have borrowed from the bank will find it impossible to obtain additional credit from the bank and are also likely to find that their loans are being called in earlier than they would like. Local regulators can benefit these local interests at no cost to themselves by declining to close the bank until long after it is insolvent.⁹¹ In addition to borrowers, bank officers and directors benefit if they can persuade their state regulators to let their bank remain open because they will be able to retain their positions during that period.⁹² Shareholders also benefit when regulators decline to close their banks in a timely fashion because they are given additional time to make last ditch attempts to recoup their investments. Thus, the allocation of regulatory authority to declare banks insolvent results in increased losses to the federal deposit insurance funds because insolvent banks are kept open longer than is optimal from the perspective of their federal insurers. The problem is exacerbated by the fact that state regulators are able to benefit local parties at the expense of national interests by declining to close insolvent depository institutions.

2. The Administration of Failed Banks

An elementary lesson in the study of the theory of corporate finance concerns the conflict of interest between fixed claimants, who prefer the firms in which they invest to pursue risk-free investment strategies, and residual claimants, who prefer the firms in which they invest to undertake high risk investments.⁹³ In the absence of regulations that distort incentives, this conflict of interest will be resolved in the contracting process. Fixed claimants will accept a lower interest rate on the money they invest in exchange for credible promises from the shareholders that the shareholders will refrain from taking excessive risks with the fixed claimants' money.⁹⁴

Thus, fixed claimants provide shareholders with a pecuniary incentive to refrain from excessive risk-taking. Those shareholders who insist on engaging in risky activities, or who are unable to offer credible promises that they will refrain from

91. The situation went from sad to deplorable when Jim Wright, the Speaker of the United States House of Representatives, began exerting the considerable political pressure on the Federal Home Loan Bank Board to induce it to forbear from closing insolvent Texas savings and loan institutions. To the extent that Mr. Wright was successful in his machinations, he was transferring wealth from a nationally sponsored insurance fund to local shareholders and debtors. See Macey & Garrett, *supra* note 1, at 221-22.

92. Unlike rank and file workers, managerial employees generally lose their jobs when the banks for which they work are declared insolvent.

93. See W. KLEIN & J. COFFEE, *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 207-09 (2d ed. 1986).

94. See Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979) (describing the various means by which contractual provisions in bond covenants insure that shareholders do not cause their firms to increase risk above the contractually specified levels).

risky activities, will be forced to bear a higher cost of capital in the form of higher interest rates on fixed claims.

Depositors in federally insured banks are fixed claimants. Insurance on deposits of less than 100,000 dollars gives these relatively small depositors no incentive to extract contractual promises from the bank to refrain from excessive risk-taking activities. Larger depositors, however, have the potential to utilize the contracting process and the price-setting capabilities in the secondary market for large certificates of deposit to exert a moderating influence on the risk-taking proclivities of bank shareholders.

Unfortunately, the policies employed by the FDIC and the FSLIC for handling the disposition of the assets and liabilities of failed banks "have transformed . . . the business of banking into a system that essentially guarantees full protection for every depositor, regardless of the size of the deposit."⁹⁵ Indeed, regulators have employed creative new strategies to avoid the traditional method of handling bank failures, the deposit payoff, which involves having a receiver liquidate the assets of the banks and make immediate payment to insured depositors up to the 100,000 dollar limit. Under a deposit payoff approach, depositors with accounts above the 100,000 dollar insured amount limit become general creditors of the bank for the uninsured portions of their deposits, sharing "proceeds from the sale of the bank assets with other general creditors (including the FDIC in its corporate capacity as insurer) on a pro rata basis after the secured creditors have been paid."⁹⁶

The other two alternatives used to dispose of failed banks both provide full protection, not only for statutorily insured depositors, but for all depositors. As such, widespread use of these alternatives to the deposit payoff, purchase and assumption transactions, and open-bank assistance programs, both deprive the regulatory system of any of the benefits to be gained by having large depositors induce banks to refrain from engaging in high levels of risk-taking.⁹⁷

In a purchase and assumption transaction, the federal insurer arranges an auction for the failed bank. Other banks bid for the assets of the failed bank and the highest bidder acquires these assets, along with all of the liabilities of the bank, such as deposits.⁹⁸ Because "all of the failed banks deposit liabilities—including deposit liabilities above 100,000 dollars—are assumed by the successful bidder"⁹⁹ in a purchase and assumption transaction, if large depositors expect this procedure to be used, they have no incentive to prompt the bank to refrain from engaging in excessive risk-taking activities. And it seems clear that the purchase and assumption transaction is the "strategy of choice" for federal regulators who handle bank failures.¹⁰⁰

Where, as in the case of the Continental Illinois National Bank and Trust

95. Macey & Garrett, *supra* note 1, at 217.

96. *Id.*

97. See Macey & Miller, *supra* note 1, at 1172-93.

98. See Burgee, *Purchase and Assumption Transactions under the Federal Deposit Insurance Act*, 14 FORUM 1146, 1154-59 (1979); Gilbert, *supra* note 8, at 22; Norcross, *The Bank Insolvency Game: FDIC Superpowers, the D'Oench Doctrine, and Federal Common Law*, 103 BANKING L.J. 316, 348 n.137 (1986).

99. Macey & Garrett, *supra* note 1, at 217-18.

100. Macey & Miller, *supra* note 1, at 1182.

Company,¹⁰¹ the insolvent bank is so big that it is not possible for the regulators to arrange a merger between the failed bank and a healthy bank, the federal insurers will employ a regulatory device called open-bank assistance, which like the purchase and assumption transaction, provides benefits to depositors in excess of the 100,000 dollar limit as well as to smaller depositors.¹⁰² As the name implies, when open-bank assistance plans are used, the troubled bank is not actually closed by its regulators. Instead, the federal insurer provides financial support and assurances that "all depositors and other general creditors of the bank will be fully protected and services to the bank's customers will not be interrupted."¹⁰³ These assurances come in the form of guarantees of credit and other promises. The financial support comes in the form of purchases of nonvoting preferred stock or debentures.¹⁰⁴ Thus, where open-bank assistance is used, not only are all depositors bailed out, regardless of their size, but also the shareholders of insolvent banks are given an additional chance as well. If the bank does well after it is given open-bank assistance, then its outstanding shares will increase in value.

Thus, current bank failure policies remove any incentive that even the largest creditors have to control risk-taking by banks. The clear beneficiaries of these policies are bank shareholders. Shareholders of banks, unlike shareholders in other firms, are free to increase the value of their shares by increasing the riskiness of their banks. In addition, they can do so without fear of economic reprisal from fixed claimants (depositors) because fixed claimants are insulated from the consequences of increased riskiness by deposit insurance and bank failure policies.

Therefore, both bank failure policies and deposit insurance pricing policies are consistent with the political theory which posits that bank regulators are "captured" by the firms they purportedly regulate. Both regulatory systems are set up so as to subsidize any additional levels of risk assumed by bank shareholders.¹⁰⁵ The political

101. See Office of the Comptroller of the Currency, FDIC and Federal Reserve Board, *A Permanent Assistance Program for Continental Illinois National Bank and Trust Company*, ISSUES IN BANK REG., Spring 1984, at 6; Joint News Release of FDIC, the Comptroller of the Currency, and the Federal Reserve Board, (May 17, 1984), reprinted in Gilbert, *supra* note 8, at 24.

102. *Statement of Policy and Criteria on Assistance to Operating Insured Banks*, 51 Fed. Reg. 44, 122-23 (FDIC 1986) (describing recent guidelines and conditions under which the FDIC will make open-bank assistance available to troubled banks).

103. See Gilbert, *supra* note 8, at 24 (quoting Joint News Release of the FDIC, the Comptroller, and the Federal Reserve Board).

104. *Id.* at 22.

105. See Macey & Garrett, *supra* note 1, at 221:

To the extent that bank regulatory policy is influenced by the regulated entities, this policy will not force banks to internalize the full costs of the risks associated with their activities. In fact, over a wide range of regulatory issues, this constituency may be as likely to lead bank regulators away from solutions to the bank failure problem as towards solutions.

(citations omitted).

Other restrictions, such as entry restrictions, lending limits, and capital adequacy requirements, seem to do a better job of reducing excessive risk-taking by banks, but, upon closer inspection, they have little impact on the problem. Entry restrictions increase prices for consumers by restricting competition, but they do not restrict banks from making risky loans. Contrary to popular belief, bank lending limits are quite liberal. A bank's basic lending limit is 15% of its unimpaired capital and surplus. 12 U.S.C. § 84 (1982). The expansion of the base from which a bank's lending limit is calculated from capital to capital plus unimpaired surplus "gave the Comptroller significant flexibility to define the lending limit." SYMONS & WHITE, *supra* note 43, at 177.

Requiring banks to maintain certain percentages of equity in their capital structure is another way of furthering the

problem facing the nation was illustrated most poignantly at the "posh Ocean Reef Club" in Key Largo, Florida where staff and members of the House and Senate Bank Committees "were treated to an all-expenses four day junket" by a banking industry financed foundation named after Senator Jake Garn. The trip was scheduled to coincide with the evaluation by Congress of alternative proposals for bailing out the troubled savings and loan industry.¹⁰⁶

IV. CONCLUSION

The previous Parts have shown how the current structure of bank regulation makes it unusually easy for banks to capture the administrative agencies and committees that are supposed to regulate them. This political capture translates into a series of banking policies that not only lead to, but also encourage, excessive risk-taking by federally insured depository institutions. Regulators cannot be expected to have the same incentives to monitor and control risk-taking as private sector actors, whose own money is at stake. As such, the only solutions to the problems created by our current regulatory regime will be to either provide regulators with direct monetary incentives for success, or else to privatize bank regulation. For example, some authorities have suggested that private insurance be employed as an alternative to federal deposit insurance.¹⁰⁷ Others, myself included, have suggested that bank regulatory policies be changed to provide additional monitoring of bank management by permitting a more robust market for bank control¹⁰⁸ and by changing the policies for administering failed banks.¹⁰⁹ Obviously, the way that deposit insurance is priced should be changed,¹¹⁰ and the FDIC should be given the authority to close insolvent depository institutions.

At present, short term political considerations appear to take priority over long term economic consequences. This suggests that the deeper problem is not devising workable and satisfactory solutions to the problems of risk-taking by banks. Rather, the deeper problem, which appears intractable, is how to design a political system that provides regulators with incentives to make public-regarding decisions, and how to provide politicians with incentives to establish such a system once we know how to design it.

interests of bank safety. This equity provides a cushion for depositors and the insurance funds in the event of insolvency. The FDIC has determined that 5% is the minimum acceptable level for equity capital, and that 6% is the preferred level for healthy institutions. *Id.* at 290. This means that banks can have 94% of their assets in the form of insured deposits and only 6% of their assets in the form of equity.

106. See Fenyuesi, *Bankers' Holiday*, U.S. NEWS & WORLD REP., Nov. 21, 1988, at 21, col. 1.

107. See Fischel, *supra* note 8, at 316-17.

108. See Macey & Miller, *supra* note 1.

109. *Id.*

110. K. Scott, *supra* note 8, at 37 ("[I]t seems highly desirable to remove the perverse incentives of the present premium structure.").